Von-Lusk, a California Limited Partnership, the Lusk Company, Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent, 104 T. C. 207 (1995)

Costs associated with pre-development activities, such as obtaining permits and zoning variances, must be capitalized under Section 263A of the Internal Revenue Code as they are part of the development process.

Summary

Von-Lusk, a partnership formed to develop raw land, deducted various pre-development costs, including costs for consultants, permit negotiations, and property taxes. The IRS disallowed these deductions, arguing that they should be capitalized under Section 263A. The Tax Court upheld the IRS's position, ruling that these expenses were integral to the development process and should be capitalized. The court emphasized that the term "produce" in Section 263A includes preliminary, non-physical steps of development, even if no actual construction had begun. This decision broadens the scope of costs that must be capitalized under tax law.

Facts

Von-Lusk, formed in 1966, owned 278 acres of raw land intended for subdivision and residential development. Between 1988 and 1990, Von-Lusk incurred costs for consultants, permit negotiations, and property taxes, which it deducted as "other deductions. " These costs were related to efforts to obtain building permits, zoning variances, and to negotiate development fees. Despite these efforts, no physical changes were made to the property during this period, and it remained used for farming.

Procedural History

The IRS issued notices of final partnership administrative adjustment (FPAA) disallowing the deductions for the years 1988, 1989, and 1990. Von-Lusk petitioned the Tax Court, which sustained the IRS's disallowance of the deductions and required capitalization of the costs under Section 263A.

Issue(s)

1. Whether costs incurred for pre-development activities, such as obtaining permits and zoning variances, must be capitalized under Section 263A of the Internal Revenue Code.
2. Whether property taxes paid during the pre-development phase must be capitalized under Section 263A.

Holding

1. Yes, because these costs are part of the development process and fall within the

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broad definition of “produce” under Section 263A.
2. Yes, because property taxes are specifically listed as indirect costs that must be capitalized under Section 263A.

Court’s Reasoning

The court interpreted Section 263A broadly, noting that Congress intended to capture a wide range of costs associated with property production to accurately reflect income. The court found that the term “produce” includes not only physical construction but also preliminary steps like obtaining permits and zoning variances, which are essential to the development process. The court rejected the argument that a physical change to the property was required for costs to be capitalized, citing the legislative intent to prevent mismatching of expenses and income. The court also distinguished this case from others, emphasizing the extensive nature of Von-Lusk’s pre-development activities. A key quote from the opinion is: “These activities represent the first steps of development. “

Practical Implications

This decision expands the scope of costs that must be capitalized under Section 263A, particularly in real estate development. Developers must now capitalize costs associated with pre-development activities, even if no physical construction has begun. This ruling may affect the timing of tax deductions and the financial planning of development projects, requiring developers to account for these costs in their project’s basis. The decision may also influence how similar cases are analyzed, with courts likely to consider a broader range of activities as part of the production process. Subsequent cases, like *Hustead v. Commissioner*, have referenced this decision, although with some distinctions based on the nature and extent of the pre-development activities involved.

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